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SUBJECT: BABACAN SCENESETTER: TURKISH ECONOMY AT A WATERSHED

11. (SBU) Summary: Minister Babacan comes to Washington at what may be a watershed moment for the Turkish economy. If Turkey officially becomes an EU accession country October 3, and recent privatization and FDI deals are consummated, Turkey will have taken another important step away from its boom-and-bust economic track record. On the other hand, a disruptive scenario can still not be ruled out, and the GOT needs to guard against complacency. Babacan has been a key player in Turkey's continued economic progress, keeping the reform program going whenever it was bogged down in domestic opposition. As ever with Babacan, the challenge is to get beyond his "everything's wonderful" spin and convey the need to guard against complacency and push through IMF-sponsored structural reforms. End Summary.

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Continued Progress on Economic Stabilization  
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12. (SBU) As Minister Babacan comes to Washington the Turkish economy's post-2001 crisis stabilization shows no sign of being derailed. Though growth has slowed to around the 5% target for 2005 from its torrid 2004 pace (GNP grew 9.9%), last year's pace still reflected pent-up demand from the immediate post-crisis period and the effect of newly-affordable credit on autos and consumer durables. There are encouraging signs the economy is moving from using unutilized capacity dating from the crisis to new investment to relieve capacity constraints. At the same time, even though overall growth has slowed, signs of a long-awaited revival in the construction sector raise hopes for faster employment creation which could finally begin to bring down Turkey's stubbornly-high unemployment rate (9.2% as of June, 2005).

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Exchange Rate Appreciation and Current Account Concerns  
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13. (SBU) One factor in the slowdown is the Turkish lira's continued real appreciation, particularly against the euro, which raises concerns about Turkey's ability to maintain the competitiveness of its exports. Coming at the same time as higher oil prices, Turkey's trade deficit is worsening in 2005, exacerbating existing concerns about Turkey's current account deficit. With global markets' yield-hungry short-term portfolio investors betting on Turkey's stabilization and EU-accession story, Turkey has had no difficulty financing its current account deficit (which the IMF forecasts will be 5.6% of GNP this year). However, this leaves Turkey vulnerable to a shift in global sentiment on emerging markets in general or Turkey in particular, which could lead to a "rush to the exits" and a disruptive fall in the exchange rate.

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FDI and Privatization Come to Life  
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14. (SBU) While the risk of the above-described disruptive scenario remains, 2005 brought major progress on both foreign direct investment and privatization--areas of notable weakness in recent years. There have been a series of major FDI deals announced that are expected to provide a significant source of longer-term stable financing to the balance of payments. One of these deals (GE Capital's \$1.56 billion purchase of a 25.5% stake in Garanti Bank) will be the first large U.S. corporate investment in Turkey in years. Combined with the resolution of Cargill's zoning problem, and the seemingly close resolution of Motorola's protracted effort to settle its \$2 billion claim, the track record for American companies has improved considerably. Nevertheless, the opaque judicial and regulatory systems continue to need reform. The AKP leadership, including Babacan, support judicial reform, but face fierce resistance from the powerful, entrenched state bureaucracy.

15. (SBU) Likewise, the AK Party Government, which tried but

mostly failed to privatize large state enterprises in 2003 and 2004, finally seems to have turned the corner with a series of major privatization tenders that are likely to be consummated. If the deals that have been tendered in 2005 are not overturned by the judiciary they will total about \$14 billion. With a Saudi-led consortium winning the Turk Telekom tender, and Shell's minority share in the Tupras oil refinery, both transactions will lead to some increased FDI as well, though spread over several years. As these deals have raised nationalist and dirigiste hackles, Prime Minister Erdogan and Babacan have shown political courage and publicly stood up for the benefits of foreign investment and privatization.

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Adding to Market Optimism  
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16. (SBU) Good news on privatization and FDI has bolstered already-optimistic Turkish financial markets, driven by foreign investors who repeatedly bet the GOT will work things out with the IMF, the EU, and the U.S. The Istanbul stock exchange keeps breaking new records, while the lira stays strong and interest rates slowly but surely move lower. If Turkey, as seems likely, officially begins EU accession negotiations October 3, it will only add to the flood of short-term portfolio investment, exacerbating the risk of a financial market bubble leading to a disruptive scenario if investor sentiment suddenly shifts in the future.

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Continued Tight Fiscal and Monetary Policy  
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17. (SBU) Consequently, despite the encouraging signs of more long-term financing from FDI, the risk from the current account deficit remains, linked as it is to Turkey's continued (albeit gradually decreasing) need to continually roll over large quantities of short-term debt in financial markets. This concern reinforces the IMF's call for continued tight monetary policy, with the GOT sticking to its 6.5% primary surplus target for 2006 and the independent Central Bank sustaining its disinflation policy, which is on track to meet this year's targeted 8% rate for CPI. At the same time, both the IMF and business groups like TOBB, Turkey's Chamber of Commerce, emphasize the need to keep moving forward on structural reforms such as the social security reform and tax reform. The social security reform is closely-linked to Turkey's fiscal policy because the longer the GOT waits to implement the reform the longer the social security deficit (4.5% of GDP) exacerbates Turkey's overall budget deficit. Though Babacan will insist the reform will be implemented as soon as parliament returns October 1, there are rumors the critical change in the pension payment formulae will be postponed from the planned January 1, 2006 start date.

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Hence the Need for Movement on the IMF Program:  
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18. (SBU) All of which points to the importance of the GOT avoiding complacency on economic policy, and moving forward on its on-again off-again IMF program. After about four months of inactivity on the IMF program at the beginning of the year, the GOT worked hard from April through June: finally securing board approval for the new \$10 billion Standby Arrangement in May and pressing parliament to pass key legislation in June, only to be derailed by fierce delaying tactics by the opposition and the long parliamentary recess which ends October 1. Babacan will insist the GOT fully owns the economic reform program and will quickly pass the banking legislation (overriding the President's typically unhelpful veto) and the social security reform, and quickly wrapping up both the first and second reviews. But Babacan's gloss masks the ambivalence of many GOT politicians, particularly on the structural reforms, and USG officials are well-advised to continually raise the IMF program, while realizing Babacan is its principal proponent in the Council of Ministers.

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Comment:  
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19. (SBU) In this context of continued economic progress coupled with continued--albeit lessening--risks, USG officials' challenge in meetings with Babacan will be to get beyond his ever-glowing spin, to have a substantive discussion about how the GOT would deal with a run of bad luck.

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